SENATE BILL No. 359

Introduced by Senator Runner

February 20, 2007

An act to amend Sections 17052.12, 17053.36, 17053.37, 23609, 23636, 23637, and 25120 of, to amend, add, and repeal Section 25128 of, and to add and repeal Sections 6357.7 and 6377 of, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

SB 359, as introduced, Runner. Sales and use taxes: exemptions.

(1) The Sales and Use Tax Law imposes a tax on the gross receipts from the sale in this state of, or the storage, use, or other consumption in this state of, tangible personal property. That law provides various exemptions from that tax, including an exemption for the gross receipts from the sale of, and the storage, use, or other consumption of, fuel and petroleum products sold to an air common carrier for immediate consumption or shipment in the conduct of its business on an international flight.

This bill would, from January 1, 2007, until an unspecified date, exempt from those state taxes gross receipts in excess of $1.88 per gallon derived from the sale in this state of, and the storage, use, or other consumption in this state of, fuel and petroleum products sold to or purchased by an air common carrier on a domestic flight, as specified.

(2) The Sales and Use Tax Law imposes a tax on the gross receipts from the sale in this state of, or the storage, use, or other consumption in this state of, tangible personal property and provides various exemptions from the taxes imposed by that law.

This bill would, for calendar years beginning on or after January 1, 2007, and before January 1, ____, allow an exemption from those taxes for the gross receipts from the sale of, and the storage, use, or other

consumption of, tangible personal property, as defined, purchased for use by a qualified person, as defined, engaged in the manufacturing, processing, refining, fabricating, or recycling of property, as specified.

(3) The Personal Income Tax Law and the Corporation Tax Law, by reference to a specified federal statute, allow a credit against taxes imposed by those laws for increasing research expenses, as defined. In general, the amount of the credit under both laws is equal to 15% of the excess of the qualified research expenses, as defined, for the taxable year over the base amount, as defined, and, in addition, for purposes of the Corporation Tax Law, 24% of the basic research payments, as defined. The term "base amount" means the product of the average annual gross receipts of the taxpayer for each of the specified years preceding the taxable year and the fixed-base percentage, as defined, but in no event less than 50% of the qualified research expenses for the taxable year. A taxpayer may elect an alternative incremental credit for increasing research expenses in modified conformity to federal income tax laws.

This bill would modify the credit for increasing research expenses to 16% of the excess of the qualified research expenses. This bill would also make modification to alternative incremental credit provided under those federal income tax laws.

(4) The Personal Income Tax Law and the Corporation Tax Law authorize various credits against the taxes imposed by those laws, including a credit against those taxes for specified taxable years, in an amount equal to a specified percentage of the qualified wages, as defined, paid, or incurred during the taxable or income year or in connection with an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter, as specified. The Personal Income Tax Law and the Corporation Tax Law also authorize a credit against the taxes imposed by those laws for specified taxable years, in an amount equal to 10% of the qualified cost, as provided, of property for use in the manufacture of a product for ultimate use in a Joint Strike Fighter, as specified. Existing law provides that these provisions are repealed on December 1, 2006.

This bill would extend these credits to the manufacture of property for ultimate use as a Crew Exploration Vehicle, as defined, and would also extend the repeal date of these provisions to December 1, ____.

(5) The Corporation Tax Law imposes taxes measured by income and, in the case of a business with income derived from or attributable to sources both within and without this state, apportions the income

between this state and other states and foreign countries in accordance with a specified 4-factor formula based on the property, payroll, and sales within and without this state, except that in the case of an apportioning trade or business that derives more than 50% of its gross business receipts from conducting one or more qualified business activities, as defined, including an extractive business activity, business income is apportioned in accordance with a specified 3-factor formula.

This bill would permit, by election, business income of a qualified taxpayer, as defined, to be apportioned to this state, for taxable years beginning on or after January 1, 2007, and before January 1, ____, by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus 4 times the sales factor, and the denominator of which is 6.

This bill would also provide that, for taxable years beginning on or after January 1, 2007, and before January 1, ____, a taxpayer that is neither a qualified taxpayer nor engaged in a specified business activity must apportion its business income to this state in accordance with the 4-factor formula, and would specify that, with respect to a certain business activity, a trade or business would be allowed to apportion its business income based upon the revised formula or in accordance with the 3-factor formula, as provided, and would specify that, with respect to certain qualified business activities, a trade or business must apportion its business income to this state in accordance with the 3-factor formula.

This bill, for purposes of the sales factor, would provide that notwithstanding the Multistate Tax Compact, gross receipts would also define the term "total sales arising from a treasury function," as defined, to mean only the overall net gain, including interest and dividends, realized by the taxpayer from transactions undertaken as part of its treasury function, as defined.

(6) Counties and cities are authorized to impose local sales and use taxes in conformity with state sales and use taxes. Exemptions from state sales and use taxes enacted by the Legislature are automatically incorporated into the local taxes.

This bill would specify that this exemption does not apply to local sales or transactions and use taxes, unless the governing body of the taxing county, city, or district votes otherwise.

(7) This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

SECTION 1. Section 6357.7 is added to the Revenue and Taxation Code, to read:

6357.7. (a) From January 1, 2007, to December 31, ____, inclusive, there are exempted from the taxes imposed by this part, those gross receipts in excess of one dollar and eighty eight cents ($1.88) per gallon derived from the sale in this state of, or the storage, use, or other consumption in this state of, fuel and petroleum products sold to or purchased by an air common carrier for consumption or shipment in the conduct of its business as an air common carrier, on a domestic flight.

(b) To qualify for the exemption, the air common carrier shall furnish to the seller an exemption certificate in the form prescribed by the board. Acceptance in good faith of that certificate shall relieve the seller from liability for the sales tax exempted under this section.

(c) For purposes of this section, the following definitions apply:

(1) "Air common carrier" has the same meaning as that set forth in Section 23046 of the Business and Professions Code.

(2) "Domestic flight" means a flight whose final destination is a point inside of the United States, including its territories.

(d) Any air common carrier claiming exemption under this section, who is not required to hold a valid seller's permit, shall be required to register with the board and obtain a fuel exemption registration number, and shall be required to file returns as the board may prescribe, either if the board notifies the carrier that returns must be filed or if the carrier is liable for taxes based upon consumption or transportation of fuel or petroleum products erroneously claimed as exempt under this section.

(e) An air common carrier claiming an exemption under this section, upon request, shall make available to the board records, including, but not limited to, a copy of a log abstract, an air waybill, or a cargo manifest, documenting its consumption or transportation of the fuel or petroleum products on a domestic flight and the amount claimed as exempt. If the carrier fails to provide these records upon request, the board may revoke the carrier's fuel exemption registration number.

(f) The board may require any air common carrier claiming an exemption under this section and required to obtain a fuel

exemption registration number, to place with it such security as the board may determine pursuant to Section 6701.

(g) Pursuant to this section, any use of the fuel and petroleum products by the purchasing carrier, other than that incident to the delivery of the fuel and petroleum products to the carrier and the consumption or transportation of the fuel and petroleum products by the carrier on a domestic flight for use in the conduct of its business as a common carrier, or a failure of the carrier to document its consumption or transportation of the fuel and petroleum products on a domestic flight, shall subject the carrier to liability for payment of sales tax as if it were a retailer making a retail sale of the property at the time of that use or failure, and the sales price of the property to it shall be deemed to be the gross receipts from the retail sale.

(h) Notwithstanding any provision of the Bradley-Burns Uniform Local Sales and Use Tax Law (Part 1.5 (commencing with Section 7200)) or the Transactions and Use Tax Law (Part 1.6 (commencing with Section 7251)), the exemption established by this section shall not apply with respect to any tax levied by a county, city, or district pursuant to, or in accordance with, either of those laws, unless approved by the local government that would otherwise receive the revenues derived from the taxes imposed under those laws.

(i) This section shall remain in effect only until January 1, ____, and as of that date is repealed.

SEC. 2. Section 6377 is added to the Revenue and Taxation Code, to read:

6377. (a) For calendar years beginning on or after January 1, 2007, there are exempted from the taxes imposed by this part the gross receipts from the sale of, and the storage, use, or other consumption in this state of, any of the following:

(1) Tangible personal property purchased for use by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of property, beginning at the point any raw materials are received by the qualified person and introduced into the process and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling has altered property to its completed form, including packaging, if required.

(2) Tangible personal property purchased for use by a qualified person to be used primarily in research and development.

(3) Tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any property described in paragraph (1), (2), or (3).

(4) Tangible personal property purchased for use by a contractor purchasing that property either as an agent of a qualified person or for the contractor's own account and subsequent resale to a qualified person for use in the performance of a construction contract for the qualified person who will use the tangible personal property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with the manufacturing process.

(b) This exemption does not apply to any tangible personal property that is used primarily in administration, general management, or marketing.

(c) For purposes of this section:

(1) "Fabricating" means to make, build, create, produce, or assemble components or property to work in a new or different manner.

(2) "Manufacturing" means the activity of converting or conditioning property by changing the form, composition, quality, or character of the property for ultimate sale at retail or use in the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any improvements to tangible personal property that result in a greater service life or greater functionality than that of the original property.

(3) "Primarily" means tangible personal property used 50 percent or more of the time in an activity described in subdivision (a).

(4) (A) "Process" means the period beginning at the point at which any raw materials are received by the qualified taxpayer and introduced into the manufacturing, processing, refining, fabricating, or recycling activity of the qualified taxpayer and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling activity of the qualified taxpayer has altered tangible personal property to its completed form, including packaging, if required. Raw materials shall be considered to have been introduced into the process when the raw materials are stored on the same premises where the qualified taxpayer's

manufacturing, processing, refining, fabricating, or recycling activity is conducted.

(B) Raw materials that are stored on premises other than where the qualified taxpayer's manufacturing, processing, refining, fabricating, or recycling activity is conducted, shall not be considered to have been introduced into the manufacturing, processing, refining, fabricating, or recycling process.

(5) "Processing" means the physical application of the materials and labor necessary to modify or change the characteristics of property.

(6) "Qualified person" means any person that is both of the following:

(A) A new trade or business. In determining whether a trade or business activity qualifies as a new trade or business, the following rules shall apply:

(i) In any case where a person purchases or otherwise acquires all or any portion of the assets of an existing trade or business (irrespective of the form of entity) that is doing business in this state (within the meaning of Section 23101), the trade or business thereafter conducted by that person (or any related person) shall not be treated as a new business if the aggregate fair market value of the acquired assets (including, real, personal, tangible, and intangible property) used by that person (or any related person) in the conduct of his or her trade or business exceeds 20 percent of the aggregate fair market value of the total assets of the trade or business being conducted by the person (or any related person). For purposes of this subparagraph only, the following rules shall apply:

(I) The determination of the relative fair market values of the acquired assets and the total assets shall be made as of the last day of the month following the quarterly period in which the person (or any related person) first uses any of the acquired trade or business assets in his or her business activity.

(II) Any acquired assets that constituted property described in Section 1221(1) of the Internal Revenue Code in the hands of the transferor shall not be treated as assets acquired from an existing trade or business, unless those assets also constitute property described in Section 1221(1) of the Internal Revenue Code in the hands of the acquiring person (or related person).

(ii) In any case where a person (or any related person) is engaged in one or more trade or business activities in this state, or has been engaged in one or more trade or business activities in this state within the preceding 36 months ("prior trade or business activity"), and thereafter commences an additional trade or business activity in this state, the additional trade or business activity shall only be treated as a new business if the additional trade or business activity is classified under a different division of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition, than are any of the person's (or any related person's) current or prior trade or business activities in this state.

(iii) In any case where a person, including all related persons, is engaged in trade or business activities wholly outside of this state and that person first commences doing business in this state (within the meaning of Section 23101) after December 31, 1993 (other than by purchase or other acquisition described in clause (i)), the trade or business activity shall be treated as a new business.

(iv) In any case where the legal form under which a trade or business activity is being conducted is changed, the change in form shall be disregarded and the determination of whether the trade or business activity is a new business shall be made by treating the person as having purchased or otherwise acquired all or any portion of the assets of an existing trade or business under the rules of clause (i).

(v) "Related person" means any person that is related to that person under either Section 267 or 318 of the Internal Revenue Code.

(vi) "Acquire" includes any gift, inheritance, transfer incident to divorce, or any other transfer, whether or not for consideration.

(B) Engaged in those lines of business described in Codes 2011 to 3999, inclusive, and Codes 7371 to 7373, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition, or engaged in telecommunication activities.

(7) Notwithstanding paragraph (6), "qualified person" shall not include any person who has conducted business activities in a new trade or business for three or more years.

(8) "Recycling" means using, reusing, or reclaiming a recyclable material to produce new or recycled property.

(9) "Refining" means the process of converting a natural resource to an intermediate or finished product.

(10) "Research and development" means those activities that are described in Section 174 of the Internal Revenue Code or in any regulations promulgated under that section.

(11) "Tangible personal property" does not include any of the following:

(A) Consumables with a normal useful life of less than one year, except as provided in subparagraph (E) of paragraph (11).

(B) Furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

(12) "Tangible personal property" includes, but is not limited to, all of the following:

(A) Machinery and equipment, including component parts and contrivances such as belts, shafts, moving parts, and operating structures.

(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, together with all repair and replacement parts with a useful life of one or more years, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party.

(C) Property used in pollution control that meets or exceeds standards established by this state or any local or regional governmental agency within this state.

(D) Special purpose buildings and foundations used as an integral part of the manufacturing, processing, refining, or fabricating process, or that constitute a research or storage facility used during the manufacturing process. Buildings used solely for warehousing purposes after completion of the manufacturing process are not included.

(E) Fuels used or consumed in the manufacturing process.

(F) Property used in recycling.

(d) No exemption is allowed under this section unless the purchaser furnishes the retailer with an exemption certificate, completed in accordance with any instructions or regulations as the board may prescribe, and the retailer subsequently furnishes

the board with a copy of the exemption certificate. The exemption certificate shall contain the sales price of the machinery or equipment that is exempt pursuant to subdivision (a).

(e) Notwithstanding any provision of the Bradley-Burns Uniform Local Sales and Use Tax Law (Part 1.5 (commencing with Section 7200)) or the Transactions and Use Tax Law (Part 1.6 (commencing with Section 7251)), the exemption established by this section does not apply with respect to any tax levied by a county, city, or district pursuant to, or in accordance with, either of those laws.

(f) (1) Notwithstanding subdivision (a), the exemption provided by this section does not apply to any sale or use of property which, within one year from the date of purchase, is either removed from California or converted from an exempt use under subdivision (a) to some other use not qualifying for the exemption.

(2) The exemption established by this section does not apply with respect to any tax levied pursuant to Sections 6051.2 and 6201.2, or pursuant to Section 35 of Article XIII of the California Constitution.

(g) If a purchaser certifies in writing to the seller that the property purchased without payment of the tax will be used in a manner entitling the seller to regard the gross receipts from the sale as exempt from the sales tax, and within one year from the date of purchase, the purchaser (1) removes that property outside California, (2) converts that property for use in a manner not qualifying for the exemption, or (3) uses that property in a manner not qualifying for the exemption, the purchaser shall be liable for payment of sales tax, with applicable interest, as if the purchaser were a retailer making a retail sale of the property at the time the property is so removed, converted, or used, and the sales price of the property to the purchaser shall be deemed the gross receipts from that retail sale.

(h) This section applies to leases of tangible personal property classified as “continuing sales” and “continuing purchases” in accordance with Sections 6006.1 and 6010.1. The exemption established by this section applies to the rentals payable pursuant to a lease, provided the lessee is a qualified person and the property is used in an activity described in subdivision (a). Rentals that meet the foregoing requirements are eligible for the exemption for a period of six years from the date of commencement of the lease.

At the close of the six-year period from the date of commencement of the lease, lease receipts are subject to tax without exemption.

(i) This section shall remain in effect only until January 1, ____, and as of that date is repealed.

SEC. 3. Section 17052.12 of the Revenue and Taxation Code is amended to read:

17052.12. For each taxable year beginning on or after January 1, 1987, there shall be allowed as a credit against the "net tax" (as defined by Section 17039) for the taxable year an amount determined in accordance with Section 41 of the Internal Revenue Code, except as follows:

(a) For each taxable year beginning before January 1, 1997, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "8 percent."

(b) (1) For each taxable year beginning on or after January 1, 1997, and before January 1, 1999, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "11 percent."

(2) For each taxable year beginning on or after January 1, 1999, and before January 1, 2000, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "12 percent."

(3) For each taxable year beginning on or after January 1, 2000, *and before January 1, 2007,* the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "15 percent."

(4) For each taxable year beginning on or after January 1, 2007, the reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "16 percent."

(c) Section 41(a)(2) of the Internal Revenue Code, relating to basic research payments, shall not apply.

(d) "Qualified research" shall include only research conducted in California.

(e) In the case where the credit allowed under this section exceeds the "net tax," the excess may be carried over to reduce the "net tax" in the following year, and succeeding years if necessary, until the credit has been exhausted.

(f) (1) With respect to any expense paid or incurred after the operative date of Section 6378, Section 41(b)(1) of the Internal Revenue Code is modified to exclude from the definition of

"qualified research expense" any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax ~~provided by~~ *under* Section 6378.

(2) For each taxable year beginning on or after January 1, 1998, the reference to "Section 501(a)" in Section 41(b)(3)(C) of the Internal Revenue Code, relating to contract research expenses, is modified to read "this part or Part 11 (commencing with Section 23001)."

(g) (1) For each taxable year beginning on or after January 1, 2000*, and before January 1, 2007*:

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

(2) *For each taxable year beginning on or after January 1, 2007, the following apply:*

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "two percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "two and one-half percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "three percent."

(3) Section 41(c)(4)(B) shall not apply and in lieu thereof an election under Section 41(c)(4)(A) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 1998. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

~~(3)~~

(4) Section 41(c)(6) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business

that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

(h) Section 41(h) of the Internal Revenue Code, relating to termination, shall not apply.

(i) Section 41(g) of the Internal Revenue Code, relating to special rule for passthrough of credit, is modified by each of the following:

(1) The last sentence shall not apply.

(2) If the amount determined under Section 41(a) of the Internal Revenue Code for any taxable year exceeds the limitation of Section 41(g) of the Internal Revenue Code, that amount may be carried over to other taxable years under the rules of subdivision (e); except that the limitation of Section 41(g) of the Internal Revenue Code shall be taken into account in each subsequent taxable year.

SEC. 4. Section 17053.36 of the Revenue and Taxation Code is amended to read:

17053.36. (a) For each taxable year beginning on or after January 1, 2001, and before January 1, ~~2006~~ ____, a qualified taxpayer shall be allowed as a credit against the "net tax," as defined in Section 17039, an amount equal to the following:

(1) Fifty percent of qualified wages paid or incurred during any taxable year beginning on or after January 1, 2001, and before January 1, 2002.

(2) Forty percent of qualified wages paid or incurred during any taxable year beginning on or after January 1, 2002, and before January 1, 2003.

(3) Thirty percent of the qualified wages paid or incurred during any taxable year beginning on or after January 1, 2003, and before January 1, 2004.

(4) Twenty percent of the qualified wages paid or incurred during any taxable year beginning on or after January 1, 2004, and before January 1, 2005.

(5) Ten percent of the qualified wages paid or incurred during any taxable year beginning on or after January 1, 2005, and before January 1, ~~2006~~ ____.

(b) For purposes of this section:

(1) (A) "Qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(B) In the case of any ~~pass-through~~ *passthrough* entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 23636 shall be allowed to the ~~pass-through~~ *passthrough* entity and passed through to the partners or shareholders in accordance with applicable provisions of this part or Part 11 (commencing with Section 23001). For purposes of this paragraph, ~~"pass-through~~ *"passthrough* entity" means any partnership or ~~S~~ *"S"* corporation.

(2) "Qualified wages" means that portion of wages paid or incurred by the qualified taxpayer during the taxable year with respect to qualified employees that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to property manufactured in this state by the qualified taxpayer for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(3) "Qualified employee" means an individual whose services for the qualified taxpayer are performed in this state and are at least 90 percent directly related to the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(4) "Joint Strike Fighter" means the next generation air combat strike aircraft developed and produced under the Joint Strike Fighter program.

(5) "Joint Strike Fighter program" means the multiservice, multinational project conducted by the United States government to develop and produce the next generation of air combat strike aircraft.

(6) "Crew Exploration Vehicle" means the next generation spacecraft being planned by the National Aeronautics and Space Administration.

(c) The credit allowed by this section shall not exceed ten thousand dollars ($10,000) per year, per qualified employee. For employees that are qualified employees for part of a taxable year, the credit shall not exceed ten thousand dollars ($10,000) multiplied by a fraction, the numerator of which is the number of months of the taxable year that the employee is a qualified employee and the denominator of which is 12.

(d) In the case where the credit allowed by this section exceeds the "net tax," the excess may be carried over to reduce the "net

tax" in the following year, and the seven succeeding years if necessary, until the credit is exhausted.

(e) No credit shall be allowed unless the credit is reflected within the bid upon which the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle* is based by reducing the amount of the bid by the amount of the credit allowable.

(f) All references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a contract or subcontract and for which a qualified taxpayer is making a claim shall be made available to the Franchise Tax Board upon request.

(g) This section shall remain in effect only until December 1, ~~2006~~ ____, and as of that date is repealed.

SEC. 5. Section 17053.37 of the Revenue and Taxation Code is amended to read:

17053.37. (a) For each taxable year beginning on or after January 1, 2001, and before January 1, ~~2006~~ ____, a qualified taxpayer shall be allowed as a credit against the "net tax," as defined in Section 17039, an amount equal to 10 percent of the qualified cost of qualified property that is placed in service in this state.

(b) (1) For purposes of this section, "qualified cost" means any costs that satisfy each of the following conditions:

(A) Except as otherwise provided in this subparagraph, is a cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition of qualified property on or after January 1, 2001, and before January 1, ~~2006~~ ____. In the case of any qualified property constructed, reconstructed, or acquired by the qualified taxpayer (or any person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) pursuant to a binding contract in existence on or before January 1, 2001, costs paid pursuant to that contract shall be subject to allocation as follows. Contract costs shall be allocated to qualified property based on a ratio of costs actually paid prior to January 1, 2001, and total contract costs actually paid. "Cost paid" shall include, without limitation, contractual deposits and option payments. To the extent of costs allocated, whether or not currently deductible or depreciable for tax purposes, to a period prior to January 1, 2001, the cost shall be deemed allocated to

property acquired before January 1, 2001, and is thus not a "qualified cost."

(B) Except for capitalized labor costs as described in subparagraph (B) of paragraph (1) of subdivision (d), is an amount upon which the qualified taxpayer has paid, directly or indirectly, as a separately stated contract amount or as determined from the records of the qualified taxpayer, sales or use tax under Part 1 (commencing with Section 6001).

(C) Is an amount properly chargeable to the capital account of the qualified taxpayer.

(2) (A) For purposes of this subdivision, any contract entered into on or after January 1, 2001, that is a successor or replacement contract to a contract that was binding before January 1, 2001, shall be treated as a binding contract in existence before January 1, 2001.

(B) If a successor or replacement contract is entered into on or after January 1, 2001, and the subject of the successor or replacement contract relates both to amounts for the construction, reconstruction, or acquisition of qualified property described in the original binding contract and to costs for the construction, reconstruction, or acquisition of qualified property not described in the original binding contract, then the portion of those amounts described in the successor or replacement contract that were not described in the original binding contract shall not be treated as costs paid or incurred pursuant to a binding contract in existence on or prior to January 1, 2001, under subparagraph (A) of paragraph (1).

(3) (A) For purposes of this section, an option contract in existence before January 1, 2001, under which a qualified taxpayer (or any other person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) had an option to acquire qualified property, shall be treated as a binding contract under the rules in paragraph (2). For purposes of this subparagraph, an option contract shall not include an option under which the optionholder will forfeit an amount less than 10 percent of the fixed option price in the event the option is not exercised.

(B) For purposes of this section, a contract shall be treated as binding even if the contract is subject to a condition.

(c) (1) For purposes of this section, "qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture

property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(2) In the case of any passthrough entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 23637 shall be allowed to the passthrough entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001) or Part 11 (commencing with Section 23001). For purposes of this paragraph, the term "passthrough entity" means any partnership or ~~S~~ *"S"* corporation.

(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the effect of this section through splitups, shell corporations, partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise.

(d) (1) For purposes of this section, "qualified property" means property that is described as either of the following:

(A) Tangible personal property that is defined in Section 1245(a)(3)(A) of the Internal Revenue Code for use by a qualified taxpayer primarily in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(B) The value of any capitalized labor costs that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to the construction or modification of property described in subparagraph (A).

(2) Qualified property does not include any of the following:

(A) Furniture.

(B) Inventory.

(C) Equipment used to store finished products that have completed the manufacturing process.

(D) Any tangible personal property that is used in administration, general management, or marketing.

(e) For purposes of this section:

(1) "Crew Exploration Vehicle" means the next generation spacecraft being planned by the National Aeronautics and Space Administration.

~~(1)~~

(2) "Fabricating" means to make, build, create, produce, or assemble components or property to work in a new or different manner.

~~(2)~~

(3) "Joint Strike Fighter" means the next generation air combat strike aircraft developed and produced under the Joint Strike Fighter program.

~~(3)~~

(4) "Joint Strike Fighter program" means the multiservice, multinational project conducted by the United States government to develop and produce the next generation of air combat strike aircraft.

~~(4)~~

(5) "Manufacturing" means the activity of converting or conditioning property by changing the form, composition, quality, or character of the property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*. Manufacturing includes any improvements to tangible personal property that result in a greater service life or greater functionality than that of the original property.

~~(5)~~

(6) "Primarily" means tangible personal property used 50 percent or more of the time in an activity described in subparagraph (A) of paragraph (1) of subdivision (d).

~~(6)~~

(7) "Process" means the period beginning at the point at which any raw materials are received by the qualified taxpayer and introduced into the manufacturing, processing, or fabricating activity of the qualified taxpayer and ending at the point at which the manufacturing, processing, or fabricating activity of the qualified taxpayer has altered tangible personal property to its completed form, including packaging, if required. Raw materials shall be considered to have been introduced into the process when the raw materials are stored on the same premises where the qualified taxpayer's manufacturing, processing, or fabricating activity is conducted. Raw materials that are stored on premises other than where the qualified taxpayer's manufacturing, processing, or fabricating activity is conducted, shall not be considered to have been introduced into the manufacturing, processing, or fabricating process.

~~(7)~~

(8) "Processing" means the physical application of the materials and labor necessary to modify or change the characteristics of property.

~~(8)~~

(9) "Qualified activities" means manufacturing, processing, or fabricating of property, beginning at the point at which any raw materials are received by the qualified taxpayer and introduced into the process and ending at the point at which the manufacturing, processing, or fabricating has altered tangible personal property to its completed form, including packaging, if required.

(f) The credit allowed under subdivision (a) shall apply to qualified property that is acquired by or subject to lease by a qualified taxpayer, subject to the following special rules:

(1) A lessor of qualified property, irrespective of whether the lessor is a qualified taxpayer, shall not be allowed the credit provided under subdivision (a) with respect to any qualified property leased to another qualified taxpayer.

(2) For purposes of paragraphs (2) and (3) of subdivision (b), "binding contract" includes any lease agreement with respect to the qualified property.

(3) (A) For purposes of determining the qualified cost paid or incurred by a lessee in any leasing transaction that is not treated as a sale under Part 1 (commencing with Section 6001), the following rules shall apply:

(i) Except as provided by subparagraph (C) of this paragraph, subparagraphs (A) and (C) of paragraph (1) of subdivision (b) shall not apply.

(ii) Except as provided in subparagraph (B) and clause (iii), the "qualified cost" upon which the lessee shall compute the credit provided under this section shall be equal to the original cost to the lessor (within the meaning of Section 18031) of the qualified property that is the subject of the lease.

(iii) The requirement of subparagraph (B) of paragraph (1) of subdivision (b) shall be treated as satisfied only if the lessor has made a timely election under either Section 6094.1 or subdivision (d) of Section 6244 and has paid sales tax reimbursement or use tax measured by the purchase price of the qualified property (within the meaning of paragraph (5) of subdivision (g) of Section 6006). For purposes of this subdivision, the amount of original cost to

the lessor which may be taken into account under clause (ii) shall not exceed the purchase price upon which sales tax reimbursement or use tax has been paid under the preceding sentence.

(B) For purposes of applying subparagraph (A) only, the following special rules shall apply:

(i) The original cost to the lessor of the qualified property shall be reduced by the amount of any original cost of that property that was taken into account by a predecessor lessee in computing the credit allowable under this section.

(ii) Clause (i) shall not apply in any case where the predecessor lessee was required to recapture the credit provided under this section pursuant to the provisions of subdivision (g).

(iii) For purposes of this section only, in any case where a successor lessor has acquired qualified property from a predecessor lessor in a transaction not treated as a sale under Part 1 (commencing with Section 6001), the original cost to the successor lessor of the qualified property shall be reduced by the amount of the original cost of the qualified property that was taken into account by any lessee of the predecessor lessor in computing the credit allowable under this section.

(C) In determining the original cost of any qualified property under this paragraph, only amounts paid or incurred by the lessor on or after January 1, 2001, and before January 1, ~~2006~~ ____, shall be taken into account. In the case of any qualified property constructed, reconstructed, or acquired by a lessor pursuant to a binding contract in existence on or prior to January 1, 2001, the allocation rule specified in subparagraph (A) of paragraph (1) of subdivision (b) shall apply in determining the original cost to the lessor of qualified property.

(D) Notwithstanding subparagraph (A), in the case of any leasing transaction for which the lessee is allowed the credit under this section and thereafter the lessee (or any party related to the lessee within the meaning of Section 267 or 318 of the Internal Revenue Code) acquires the qualified property from the lessor (or any successor lessor) within one year from the date the qualified property is first used by the lessee under the terms of the lease, the lessee's (or related party's) acquisition of the qualified property from the lessor (or successor lessor) shall be treated as a disposition by the lessee of the qualified property that was subject to the lease under subdivision (g).

(4) For purposes of determining the qualified cost paid or incurred by a lessee in any leasing transaction that is treated as a sale under Part 1 (commencing with Section 6001), the following rules shall apply:

(A) Subparagraph (A) of paragraph (1) of subdivision (b) shall be applied by substituting the term "purchase" for the term "construction, reconstruction, or acquisition."

(B) Subparagraph (C) of paragraph (1) of subdivision (b) shall apply.

(C) The requirement of subparagraph (B) of paragraph (1) of subdivision (b) shall be treated as satisfied at the time that either the lessor or the qualified taxpayer pays sales or use tax under Part 1 (commencing with Section 6001).

(5) (A) In the case of any leasing transaction described in paragraph (3), the lessor shall provide a statement to the lessee specifying the amount of the lessor's original cost of the qualified property and the amount of that cost upon which a sales or use tax was paid within 45 days after the close of the lessee's taxable year in which the credit is allowable to the lessee under this section.

(B) The statement required under subparagraph (A) shall be made available to the Franchise Tax Board upon request.

(g) No credit shall be allowed if the qualified property is removed from the state, is disposed of to an unrelated party, or is used for any purpose not qualifying for the credit provided in this section in the same taxable year in which the taxpayer first places the qualified property in service in this state. If any qualified property for which a credit is allowed pursuant to this section is thereafter removed from this state, disposed of to an unrelated party, or used for any purpose not qualifying for the credit provided in this section within one year from the date the taxpayer first places the qualified property in service in this state, the amount of the credit allowed by this section for that qualified property shall be recaptured by adding that credit amount to the net tax of the qualified taxpayer for the taxable year in which the qualified property is disposed of, removed, or put to an ineligible use.

(h) In the case where the credit allowed by this section exceeds the "net tax," the excess may be carried over to reduce the "net tax" in the following year, and the seven succeeding years if necessary, until the credit is exhausted.

(i) (1) No credit shall be allowed under this section if a credit is claimed under Section 17053.49 in connection with the same property.

(2) No credit shall be allowed unless the credit is reflected within the bid upon which the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle* is based by reducing the amount of the bid by the amount of the credit allowable.

(j) All references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a contract or subcontract and for which a qualified taxpayer is making a claim shall be made available to the Franchise Tax Board upon request.

(k) This section shall remain in effect only until December 1, ~~2006~~ ____, and as of that date is repealed.

SEC. 6. Section 23609 of the Revenue and Taxation Code is amended to read:

23609. For each taxable year beginning on or after January 1, 1987, there shall be allowed as a credit against the "tax" (as defined by Section 23036) an amount determined in accordance with Section 41 of the Internal Revenue Code, except as follows:

(a) For each taxable year beginning before January 1, 1997, both of the following modifications shall apply:

(1) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "8 percent."

(2) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "12 percent."

(b) (1) For each taxable year beginning on or after January 1, 1997, and before January 1, 1999, both of the following modifications shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "11 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(2) For each taxable year beginning on or after January 1, 1999, and before January 1, 2000, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "12 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(3) For each taxable year beginning on or after January 1, 2000, *and before January 1, 2007,* both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "15 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(4) For each taxable year beginning on or after January 1, 2007, both of the following shall apply:

(A) The reference to "20 percent" in Section 41(a)(1) of the Internal Revenue Code is modified to read "16 percent."

(B) The reference to "20 percent" in Section 41(a)(2) of the Internal Revenue Code is modified to read "24 percent."

(c) (1) With respect to any expense paid or incurred after the operative date of Section 6378, Section 41(b)(1) of the Internal Revenue Code is modified to exclude from the definition of "qualified research expense" any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax ~~provided by~~ *under* Section 6378.

(2) "Qualified research" and "basic research" shall include only research conducted in California.

(d) The provisions of Section 41(e)(7)(A) of the Internal Revenue Code, shall be modified so that "basic research," for purposes of this section, includes any basic or applied research including scientific inquiry or original investigation for the advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, except that the term does not include any of the following:

(1) Basic research conducted outside California.

(2) Basic research in the social sciences, arts, or humanities.

(3) Basic research for the purpose of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors.

(4) Any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).

(e) (1) In the case of a taxpayer engaged in any biopharmaceutical research activities that are described in codes 2833 to 2836, inclusive, or any research activities that are described in codes 3826, 3829, or 3841 to 3845, inclusive, of the Standard Industrial Classification (SIC) Manual published by the United

States Office of Management and Budget, 1987 edition, or any other biotechnology research and development activities, the provisions of Section 41(e)(6) of the Internal Revenue Code shall be modified to include both of the following:

(A) A qualified organization as described in Section 170(b)(1)(A)(iii) of the Internal Revenue Code and owned by an institution of higher education as described in Section 3304(f) of the Internal Revenue Code.

(B) A charitable research hospital owned by an organization that is described in Section 501(c)(3) of the Internal Revenue Code, is exempt from taxation under Section 501(a) of the Internal Revenue Code, is not a private foundation, is designated a "specialized laboratory cancer center," and has received Clinical Cancer Research Center status from the National Cancer Institute.

(2) For purposes of this subdivision:

(A) "Biopharmaceutical research activities" means those activities that use organisms or materials derived from organisms, and their cellular, subcellular, or molecular components, in order to provide pharmaceutical products for human or animal therapeutics and diagnostics. Biopharmaceutical activities make use of living organisms to make commercial products, as opposed to pharmaceutical activities that make use of chemical compounds to produce commercial products.

(B) "Other biotechnology research and development activities" means research and development activities consisting of the application of recombinant DNA technology to produce commercial products, as well as research and development activities regarding pharmaceutical delivery systems designed to provide a measure of control over the rate, duration, and site of pharmaceutical delivery.

(f) In the case where the credit allowed by this section exceeds the "tax," the excess may be carried over to reduce the "tax" in the following year, and succeeding years if necessary, until the credit has been exhausted.

(g) For each taxable year beginning on or after January 1, 1998, the reference to "Section 501(a)" in Section 41(b)(3)(C) of the Internal Revenue Code, relating to contract research expenses, is modified to read "this part or Part 10 (commencing with Section 17001)."

(h) (1) For each taxable year beginning on or after January 1, 2000, *and before January 1, 2007*:

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "one and forty-nine hundredths of one percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "one and ninety-eight hundredths of one percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "two and forty-eight hundredths of one percent."

(2) *For each taxable year beginning on or after January 1, 2007, the following apply:*

(A) The reference to "2.65 percent" in Section 41(c)(4)(A)(i) of the Internal Revenue Code is modified to read "two percent."

(B) The reference to "3.2 percent" in Section 41(c)(4)(A)(ii) of the Internal Revenue Code is modified to read "two and one-half percent."

(C) The reference to "3.75 percent" in Section 41(c)(4)(A)(iii) of the Internal Revenue Code is modified to read "three percent."

(3) Section 41(c)(4)(B) shall not apply and in lieu thereof an election under Section 41(c)(4)(A) of the Internal Revenue Code may be made for any taxable year of the taxpayer beginning on or after January 1, 1998. That election shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Franchise Tax Board.

~~(3)~~

(4) Section 41(c)(6) of the Internal Revenue Code, relating to gross receipts, is modified to take into account only those gross receipts from the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser within this state, regardless of f.o.b. point or any other condition of the sale.

(i) Section 41(h) of the Internal Revenue Code, relating to termination, shall not apply.

(j) Section 41(g) of the Internal Revenue Code, relating to special rule for passthrough of credit, is modified by each of the following:

(1) The last sentence shall not apply.

(2) If the amount determined under Section 41(a) of the Internal Revenue Code for any taxable year exceeds the limitation of Section 41(g) of the Internal Revenue Code, that amount may be carried over to other taxable years under the rules of subdivision (f), except that the limitation of Section 41(g) of the Internal Revenue Code shall be taken into account in each subsequent taxable year.

SEC. 7. Section 23636 of the Revenue and Taxation Code is amended to read:

23636. (a) For each taxable year beginning on or after January 1, 2001, and before January 1, ~~2006~~ ____, a qualified taxpayer shall be allowed as a credit against the "tax," as defined in Section 23036, an amount equal to the following:

(1) Fifty percent of qualified wages paid or incurred during any taxable year beginning on or after January 1, 2001, and before January 1, 2002.

(2) Forty percent of qualified wages paid or incurred during any taxable year beginning on or after January 1, 2002, and before January 1, 2003.

(3) Thirty percent of the qualified wages paid or incurred during any taxable year beginning on or after January 1, 2003, and before January 1, 2004.

(4) Twenty percent of the qualified wages paid or incurred during any taxable year beginning on or after January 1, 2004, and before January 1, 2005.

(5) Ten percent of the qualified wages paid or incurred during any taxable year beginning on or after January 1, 2005, and before January 1, ~~2006~~ ____.

(b) For purposes of this section:

(1) (A) "Qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(B) In the case of any ~~pass-through~~ *passthrough* entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 17053.36 shall be allowed to the ~~pass-through~~ *passthrough* entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001) or this part. For purposes

of this paragraph, ~~"pass-through~~ *"passthrough* entity" means any partnership or S corporation.

(2) "Qualified wages" means that portion of wages paid or incurred by the qualified taxpayer during the taxable year with respect to qualified employees that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to property manufactured in this state by the qualified taxpayer for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(3) "Qualified employee" means an individual whose services for the qualified taxpayer are performed in this state and are at least 90 percent directly related to the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(4) "Joint Strike Fighter" means the next generation air combat strike aircraft developed and produced under the Joint Strike Fighter program.

(5) "Joint Strike Fighter program" means the multiservice, multinational project conducted by the United States government to develop and produce the next generation of air combat strike aircraft.

(6) "Crew Exploration Vehicle" means the next generation spacecraft being planned by the National Aeronautics and Space Administration.

(c) The credit allowed by this section shall not exceed ten thousand dollars ($10,000) per year, per qualified employee. For employees that are qualified employees for part of a taxable year, the credit shall not exceed ten thousand dollars ($10,000) multiplied by a fraction, the numerator of which is the number of months of the taxable year that the employee is a qualified employee and the denominator of which is 12.

(d) In the case where the credit allowed by this section exceeds the "tax," the excess may be carried over to reduce the "tax" in the following year, and the seven succeeding years if necessary, until the credit is exhausted.

(e) No credit shall be allowed unless the credit is reflected within the bid upon which the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike ~~Fighter~~ *Fighter or a Crew Exploration Vehicle* is based by reducing the amount of the bid by the amount of the credit allowable.

(f) All references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a contract or subcontract and for which a qualified taxpayer is making a claim shall be made available to the Franchise Tax Board upon request.

(g) This section shall remain in effect only until December 1, ~~2006~~ ____, and as of that date is repealed.

SEC. 8. Section 23637 of the Revenue and Taxation Code is amended to read:

23637. (a) For each taxable year beginning on or after January 1, 2001, and before January 1, ~~2006~~ ____, a qualified taxpayer shall be allowed as a credit against the "tax," as defined in Section 23036, an amount equal to 10 percent of the qualified cost of qualified property that is placed in service in this state.

(b) (1) For purposes of this section, "qualified cost" means any costs that satisfy each of the following conditions:

(A) Except as otherwise provided in this subparagraph, is a cost paid or incurred by the qualified taxpayer for the construction, reconstruction, or acquisition of qualified property on or after January 1, 2001, and before January 1, ~~2006~~_____. In the case of any qualified property constructed, reconstructed, or acquired by the qualified taxpayer (or any person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) pursuant to a binding contract in existence on or before January 1, 2001, costs paid pursuant to that contract shall be subject to allocation as follows. Contract costs shall be allocated to qualified property based on a ratio of costs actually paid prior to January 1, 2001, and total contract costs actually paid. "Cost paid" shall include, without limitation, contractual deposits and option payments. To the extent of costs allocated, whether or not currently deductible or depreciable for tax purposes, to a period prior to January 1, 2001, the cost shall be deemed allocated to property acquired before January 1, 2001, and is thus not a "qualified cost."

(B) Except for capitalized labor costs as described in subparagraph (B) of paragraph (1) of subdivision (d), is an amount upon which the qualified taxpayer has paid, directly or indirectly, as a separately stated contract amount or as determined from the records of the qualified taxpayer, sales or use tax under Part 1 (commencing with Section 6001).

(C) Is an amount properly chargeable to the capital account of the qualified taxpayer.

(2) (A) For purposes of this subdivision, any contract entered into on or after January 1, 2001, that is a successor or replacement contract to a contract that was binding before January 1, 2001, shall be treated as a binding contract in existence before January 1, 2001.

(B) If a successor or replacement contract is entered into on or after January 1, 2001, and the subject of the successor or replacement contract relates both to amounts for the construction, reconstruction, or acquisition of qualified property described in the original binding contract and to costs for the construction, reconstruction, or acquisition of qualified property not described in the original binding contract, then the portion of those amounts described in the successor or replacement contract that were not described in the original binding contract shall not be treated as costs paid or incurred pursuant to a binding contract in existence on or prior to January 1, 2001, under subparagraph (A) of paragraph (1).

(3) (A) For purposes of this section, an option contract in existence before January 1, 2001, under which a qualified taxpayer (or any other person related to the qualified taxpayer within the meaning of Section 267 or 707 of the Internal Revenue Code) had an option to acquire qualified property, shall be treated as a binding contract under the rules in paragraph (2). For purposes of this subparagraph, an option contract shall not include an option under which the optionholder will forfeit an amount less than 10 percent of the fixed option price in the event the option is not exercised.

(B) For purposes of this section, a contract shall be treated as binding even if the contract is subject to a condition.

(c) (1) For purposes of this section, "qualified taxpayer" means any taxpayer under an initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(2) In the case of any passthrough entity, the determination of whether a taxpayer is a qualified taxpayer under this section shall be made at the entity level and any credit under this section or Section 17053.37 shall be allowed to the passthrough entity and passed through to the partners or shareholders in accordance with applicable provisions of Part 10 (commencing with Section 17001)

or Part 11 (commencing with Section 23001). For purposes of this paragraph, the term "passthrough entity" means any partnership or ~~S~~ *"S"* corporation.

(3) The Franchise Tax Board may prescribe regulations to carry out the purposes of this section, including any regulations necessary to prevent the avoidance of the effect of this section through splitups, shell corporations, partnerships, tiered ownership structures, sale-leaseback transactions, or otherwise.

(d) (1) For purposes of this section, "qualified property" means property that is described as either of the following:

(A) Tangible personal property that is defined in Section 1245(a)(3)(A) of the Internal Revenue Code for use by a qualified taxpayer primarily in qualified activities to manufacture a product for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*.

(B) The value of any capitalized labor costs that are direct costs as defined in Section 263A of the Internal Revenue Code allocable to the construction or modification of property described in subparagraph (A).

(2) Qualified property does not include any of the following:

(A) Furniture.

(B) Inventory.

(C) Equipment used to store finished products that have completed the manufacturing process.

(D) Any tangible personal property that is used in administration, general management, or marketing.

(e) For purposes of this section:

(1) *"Crew Exploration Vehicle" means the next generation spacecraft being planned by the National Aeronautics and Space Administration.*

(2) "Fabricating" means to make, build, create, produce, or assemble components or property to work in a new or different manner.

~~(2)~~

(3) "Joint Strike Fighter" means the next generation air combat strike aircraft developed and produced under the Joint Strike Fighter program.

~~(3)~~

(4) "Joint Strike Fighter program" means the multiservice, multinational project conducted by the United States government

to develop and produce the next generation of air combat strike aircraft.

~~(4)~~

(5) "Manufacturing" means the activity of converting or conditioning property by changing the form, composition, quality, or character of the property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle*. Manufacturing includes any improvements to tangible personal property that result in a greater service life or greater functionality than that of the original property.

~~(5)~~

(6) "Primarily" means tangible personal property used 50 percent or more of the time in an activity described in subparagraph (A) of paragraph (1) of subdivision (d).

~~(6)~~

(7) "Process" means the period beginning at the point at which any raw materials are received by the qualified taxpayer and introduced into the manufacturing, processing, or fabricating activity of the qualified taxpayer and ending at the point at which the manufacturing, processing, or fabricating activity of the qualified taxpayer has altered tangible personal property to its completed form, including packaging, if required. Raw materials shall be considered to have been introduced into the process when the raw materials are stored on the same premises where the qualified taxpayer's manufacturing, processing, or fabricating activity is conducted. Raw materials that are stored on premises other than where the qualified taxpayer's manufacturing, processing, or fabricating activity is conducted, shall not be considered to have been introduced into the manufacturing, processing, or fabricating process.

~~(7)~~

(8) "Processing" means the physical application of the materials and labor necessary to modify or change the characteristics of property.

~~(8)~~

(9) "Qualified activities" means manufacturing, processing, or fabricating of property, beginning at the point at which any raw materials are received by the qualified taxpayer and introduced into the process and ending at the point at which the manufacturing,

processing, or fabricating has altered tangible personal property to its completed form, including packaging, if required.

(f) The credit allowed under subdivision (a) shall apply to qualified property that is acquired by or subject to lease by a qualified taxpayer, subject to the following special rules:

(1) A lessor of qualified property, irrespective of whether the lessor is a qualified taxpayer, shall not be allowed the credit provided under subdivision (a) with respect to any qualified property leased to another qualified taxpayer.

(2) For purposes of paragraphs (2) and (3) of subdivision (b), "binding contract" includes any lease agreement with respect to the qualified property.

(3) (A) For purposes of determining the qualified cost paid or incurred by a lessee in any leasing transaction that is not treated as a sale under Part 1 (commencing with Section 6001), the following rules shall apply:

(i) Except as provided by subparagraph (C) of this paragraph, subparagraphs (A) and (C) of paragraph (1) of subdivision (b) shall not apply.

(ii) Except as provided in subparagraph (B) and clause (iii), the "qualified cost" upon which the lessee shall compute the credit provided under this section shall be equal to the original cost to the lessor (within the meaning of Section 18031) of the qualified property that is the subject of the lease.

(iii) The requirement of subparagraph (B) of paragraph (1) of subdivision (b) shall be treated as satisfied only if the lessor has made a timely election under either Section 6094.1 or subdivision (d) of Section 6244 and has paid sales tax reimbursement or use tax measured by the purchase price of the qualified property (within the meaning of paragraph (5) of subdivision (g) of Section 6006). For purposes of this subdivision, the amount of original cost to the lessor which may be taken into account under clause (ii) shall not exceed the purchase price upon which sales tax reimbursement or use tax has been paid under the preceding sentence.

(B) For purposes of applying subparagraph (A) only, the following special rules shall apply:

(i) The original cost to the lessor of the qualified property shall be reduced by the amount of any original cost of that property that was taken into account by a predecessor lessee in computing the credit allowable under this section.

(ii) Clause (i) shall not apply in any case where the predecessor lessee was required to recapture the credit provided under this section pursuant to the provisions of subdivision (g).

(iii) For purposes of this section only, in any case where a successor lessor has acquired qualified property from a predecessor lessor in a transaction not treated as a sale under Part 1 (commencing with Section 6001), the original cost to the successor lessor of the qualified property shall be reduced by the amount of the original cost of the qualified property that was taken into account by any lessee of the predecessor lessor in computing the credit allowable under this section.

(C) In determining the original cost of any qualified property under this paragraph, only amounts paid or incurred by the lessor on or after January 1, 2001, and before January 1, ~~2006~~_____, shall be taken into account. In the case of any qualified property constructed, reconstructed, or acquired by a lessor pursuant to a binding contract in existence on or prior to January 1, 2001, the allocation rule specified in subparagraph (A) of paragraph (1) of subdivision (b) shall apply in determining the original cost to the lessor of qualified property.

(D) Notwithstanding subparagraph (A), in the case of any leasing transaction for which the lessee is allowed the credit under this section and thereafter the lessee (or any party related to the lessee within the meaning of Section 267 or 318 of the Internal Revenue Code) acquires the qualified property from the lessor (or any successor lessor) within one year from the date the qualified property is first used by the lessee under the terms of the lease, the lessee's (or related party's) acquisition of the qualified property from the lessor (or successor lessor) shall be treated as a disposition by the lessee of the qualified property that was subject to the lease under subdivision (g).

(4) For purposes of determining the qualified cost paid or incurred by a lessee in any leasing transaction that is treated as a sale under Part 1 (commencing with Section 6001), the following rules shall apply:

(A) Subparagraph (A) of paragraph (1) of subdivision (b) shall be applied by substituting the term "purchase" for the term "construction, reconstruction, or acquisition."

(B) Subparagraph (C) of paragraph (1) of subdivision (b) shall apply.

(C) The requirement of subparagraph (B) of paragraph (1) of subdivision (b) shall be treated as satisfied at the time that either the lessor or the qualified taxpayer pays sales or use tax under Part 1 (commencing with Section 6001).

(5) (A) In the case of any leasing transaction described in paragraph (3), the lessor shall provide a statement to the lessee specifying the amount of the lessor's original cost of the qualified property and the amount of that cost upon which a sales or use tax was paid within 45 days after the close of the lessee's taxable year in which the credit is allowable to the lessee under this section.

(B) The statement required under subparagraph (A) shall be made available to the Franchise Tax Board upon request.

(g) No credit shall be allowed if the qualified property is removed from the state, is disposed of to an unrelated party, or is used for any purpose not qualifying for the credit provided in this section in the same taxable year in which the taxpayer first places the qualified property in service in this state. If any qualified property for which a credit is allowed pursuant to this section is thereafter removed from this state, disposed of to an unrelated party, or used for any purpose not qualifying for the credit provided in this section within one year from the date the taxpayer first places the qualified property in service in this state, the amount of the credit allowed by this section for that qualified property shall be recaptured by adding that credit amount to the tax of the qualified taxpayer for the taxable year in which the qualified property is disposed of, removed, or put to an ineligible use.

(h) In the case where the credit allowed by this section exceeds the "tax," the excess may be carried over to reduce the "tax" in the following year, and the seven succeeding years if necessary, until the credit is exhausted.

(i) (1) No credit shall be allowed under this section if a credit is claimed under Section 23649 in connection with the same property.

(2) No credit shall be allowed unless the credit is reflected within the bid upon which the qualified taxpayer's contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter *or a Crew Exploration Vehicle* is based by reducing the amount of the bid by the amount of the credit allowable.

(j) All references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a contract

or subcontract and for which a qualified taxpayer is making a claim shall be made available to the Franchise Tax Board upon request.

(k) This section shall remain in effect only until December 1, ~~2006~~ ____, and as of that date is repealed.

SEC. 9. Section 25120 of the Revenue and Taxation Code is amended to read:

25120. As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) *(1)* "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes *all income arising from the treasury function of the taxpayer's trade or business and* income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(2) "Income arising from the treasury function" means interest, dividends, and any overall net gain realized from transactions undertaken as part of the treasury function of the taxpayer's trade or business.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) *(1)* "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

~~(f)~~

(2) (A) Notwithstanding Section 38006, gross receipts arising from a treasury function shall be limited to the overall net gain, including interest and dividends, realized from transactions undertaken as part of a treasury function.

(B) Subparagraph (A) does not apply to the activities of a broker-dealer that is registered with the Securities and Exchange Commission or equivalent federal agency.

(f) For purposes of this section, all of the following definitions apply:

(1) "Treasury function" means the pooling, management, and investment of liquid assets. "Treasury function" does not include a taxpayer's trading function that purchases and sells future contracts, products, or commodities related to the business of the taxpayer, or related to hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.

(2) (A) "Liquid asset" means a readily marketable intangible, including, but not limited to, bonds, stocks, future contracts, debentures, options warrants, foreign currency, and mutual funds that hold those intangibles. "Liquid asset" does not mean currency held in bank accounts if that is the currency that the business regularly used in the conduct of its trade or business, unless that currency is an instrument that may be purchased or sold for a gain or loss.

(B) An intangible is considered "marketable" if it is traded on an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

(g) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

(h) The amendments made to this section by the act adding this subdivision shall be operative for taxable years beginning on or after January 1, 2006.

SEC. 10. Section 25128 of the Revenue and Taxation Code is amended to read:

25128. (a) Notwithstanding Section 38006, *for taxable years beginning before January 1, 2007, and for taxable years beginning on or after January 1,____*, all business income shall be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four, except as provided in subdivision (b) or (c).

(b) If an apportioning trade or business derives more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities, all business income of the apportioning trade or business shall be apportioned to this state by multiplying business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

(c) For purposes of this section, a "qualified business activity" means the following:

(1) An agricultural business activity.

(2) An extractive business activity.

(3) A savings and loan activity.

(4) A banking or financial business activity.

(d) For purposes of this section:

(1) "Gross business receipts" means gross receipts described in subdivision (e) of Section 25120 (other than gross receipts from sales or other transactions within an apportioning trade or business between members of a group of corporations whose income and apportionment factors are required to be included in a combined report under Section 25101, limited, if applicable, by Section 25110), whether or not the receipts are excluded from the sales factor by operation of Section 25137.

(2) "Agricultural business activity" means activities relating to any stock, dairy, poultry, fruit, furbearing animal, or truck farm, plantation, ranch, nursery, or range. "Agricultural business activity" also includes activities relating to cultivating the soil or raising or harvesting any agricultural or horticultural commodity, including, but not limited to, the raising, shearing, feeding, caring for, training, or management of animals on a farm as well as the handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated.

(3) "Extractive business activity" means activities relating to the production, refining, or processing of oil, natural gas, or mineral ore.

(4) "Savings and loan activity" means any activities performed by savings and loan associations or savings banks which have been chartered by federal or state law.

(5) "Banking or financial business activity" means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(6) "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors.

(7) Paragraph (4) of subdivision (c) shall apply only if the Franchise Tax Board adopts the Proposed Multistate Tax Commission Formula for the Uniform Apportionment of Net Income from Financial Institutions, or its substantial equivalent, and shall become operative upon the same operative date as the adopted formula.

(8) In any case where the income and apportionment factors of two or more savings associations or corporations are required to be included in a combined report under Section 25101, limited, if applicable, by Section 25110, both of the following shall apply:

(A) The application of the more than 50 percent test of subdivision (b) shall be made with respect to the "gross business receipts" of the entire apportioning trade or business of the group.

(B) The entire business income of the group shall be apportioned in accordance with either subdivision (a) or (b), as applicable.

SEC. 11. Section 25128 is added to the Revenue and Taxation Code, to read:

25128. (a) Notwithstanding Section 38006, for taxable years beginning on or after January 1, 2007, and before January 1, ____, all business income of an apportioning trade or business shall be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor and the denominator of which is four, except as provided in subdivision (b), (c), or (e).

(b) (1) If an apportioning trade or business is a qualified taxpayer, the qualified taxpayer may elect to have all business income apportioned to this state for taxable years beginning on or after January 1, 2007, and before January 1, ____, by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus four times the sales factor, and the denominator of which is six. The Franchise Tax Board shall prescribe the form and manner for making the election under this paragraph. No election may be made for a taxable year beginning prior to January 1, 2007.

(2) A qualified taxpayer making the election under this subdivision shall source sales of prewritten software as tangible personal property pursuant to Section 25135, without regard to method of delivery.

(3) (A) For purposes of this section, "qualified taxpayer" means an apportioning trade or business that derives more than 50 percent

of its "gross business receipts" from conducting a business activity, or combination of activities, described in Principal Business Activity Code (PBAC) 312130, 325410, 333200 (to the extent of semiconductor machinery manufacturing only), 334110, 334200, 334410, 339110, 511210, 517000, 512100, 515100, 515210, or 713100 as prescribed by the Internal Revenue Service.

(B) A taxpayer that does not satisfy the requirements of subparagraph (A) and that derives more than one billion dollars ($1,000,000,000) of "gross business receipts" from conducting a business activity or combination of activities described in PBAC 312130, 325410, 333200 (to the extent of semiconductor machinery manufacturing only), 334110, 334200, 334410, 339110, 511210, 517000, 512100, 515100, 515210, or 713100 may elect, on a timely filed original return, to be a qualified taxpayer and to multiply business income by a fraction (hereinafter referred to as the "applicable percentage"), the numerator and the denominator of which shall be determined as set forth under paragraph (1) of subdivision (b). The application of the more than one billion dollars ($1,000,000,000) test shall be made with respect to the combined "gross business receipts" of all members of the apportioning trade or business that are engaged in one or more activities described in this subparagraph.

The one-time binding election under this subparagraph shall be made by contract with the Franchise Tax Board in the original return. The Franchise Tax Board shall prescribe the form and manner for making the election under this subparagraph. No election may be made for a taxable year beginning prior to January 1, 2007.

(C) For purposes of subparagraph (B), "qualified taxpayer" includes all members of the apportioning trade or business that are engaged in one or more activities described in subparagraph (B).

(D) If a qualified taxpayer described in subparagraph (B) is included in a single combined report under Section 25101 or 25110 with one or more taxpayers that are not qualified taxpayers, to apportion the business income of the entire combined group, both of the following shall apply:

(i) The numerator of each factor for the qualified taxpayer shall be the denominator of the factor for the qualified taxpayer multiplied by the applicable percentage described in subparagraph (B) for that qualified taxpayer.

(ii) The numerators for each of the factors under this subparagraph shall be added to the numerators of the other members of the combined group when determining the apportionment factor that will be used by the combined group.

(c) (1) If an apportioning trade or business derives more than 50 percent of its "gross business receipts" from conducting a business activity, or combination of activities, described in PBAC 211110, 221210, 324110, 324190, 424700, 425120, 447100, 454312, 486000, or 523130 as prescribed by the Internal Revenue Service, the taxpayer may elect on a timely filed original return to apportion all business income of the apportioning trade or business to this state either in the same manner as a qualified taxpayer pursuant to subdivision (b), or by multiplying business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

(2) The one-time binding election under paragraph (1) shall be made by contract with the Franchise Tax Board in the original return. The Franchise Tax Board shall prescribe the form and manner for making the election. No election may be made for a taxable year beginning prior to January 1, 2007.

(d) An election under subdivision (b) or (c) may be terminated by the taxpayer if either of the following occurs:

(1) The taxpayer is acquired directly or indirectly by a nonelecting entity that alone or together with those affiliates included in its combined report is larger than the taxpayer as measured by equity capital.

(2) With the permission of the Franchise Tax Board.

(e) If an apportioning trade or business derives more than 50 percent of its gross business receipts from conducting one or more qualified business activities, all business income of the apportioning trade or business shall be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

For purposes of this subdivision, a "qualified business activity" means the following:

(1) An agricultural business activity.

(2) A savings and loan activity.

(3) A banking or financial business activity.

(f) For purposes of this section, all of the following definitions apply:

(1) (A) "Gross business receipts" means gross receipts described in subdivision (e) of Section 25120, other than gross receipts from sales or other transactions within an apportioning trade or business between members of a group of corporations whose income and apportionment factors are required to be included in a combined report under Section 25101, limited, if applicable, by Section 25110, whether or not the receipts are excluded from the sales factor by operation of Section 25137.

(B) "Gross business receipts" does not include sales arising from a treasury function of the taxpayer's trade or business, as defined in subdivision (f) of Section 25120.

(2) (A) "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors.

(B) In any case where the income and apportionment factors of two or more savings and loan associations, banks, or corporations as described in subdivision (b), (c), or (e) are required to be included in a combined report under Section 25101, limited, if applicable, by Section 25110, both of the following shall apply:

(i) The application of the more than 50-percent test of subdivision (b), (c), or (e) shall be made with respect to the "gross business receipts" of the entire apportioning trade or business of the group.

(ii) The entire business income of the group shall be apportioned in accordance with subdivision (b), (c), or (e), as applicable.

(3) "Agricultural business activity" means activities relating to any stock, dairy, poultry, fruit, furbearing animal, or truck farm, plantation, ranch, nursery, or range. "Agricultural business activity" also includes activities relating to cultivating the soil or raising or harvesting any agricultural or horticultural commodity, including, but not limited to, the raising, shearing, feeding, caring for, training, or management of animals on a farm as well as the handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated.

(4) "Savings and loan activity" means any activities performed by savings and loan associations or savings banks that have been chartered by federal or state law.

(5) "Banking or financial business activity" means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

(6) "Equity capital" means issued stock of any class, paid-in capital and retained earnings, or earned surplus, as set forth on the balance sheet of the taxpayer or the nonelecting entity, for the immediately preceding year-end accounting period.

(7) All references to Principal Business Activity Codes are as prescribed by the Internal Revenue Service on December 31, 2005.

(g) Any change in the apportionment formula caused by this section is not consideration for granting a change of the water's-edge election pursuant to Section 25113.

(h) If this section or any portion of this section is held invalid, or the application of this section to any person or circumstance is held invalid, that invalidity shall not affect other provisions of the act adding this section, or the provisions of this section that can be reasonably separated pursuant to Section 23057.

(i) This section shall become operative on January 1, 2007, and shall remain in effect only until January 1, ____, and of the date is repealed unless a later enacted statue, which is chaptered before January 1, ____, deletes or extends that date.

SEC. 12. Any governing body of any county, city, or district that votes to allow the exemption provided in Section 6357.7 of the Revenue and Taxation Code shall notify the State Board of Equalization on or before December 1, 2006.

SEC. 13. This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect.

O